At a time when the world’s attention was primarily gripped by the BRICS\(^1\) and SCO\(^2\) summits and the meetings of leaders of the world’s significant powers and emerging economies, a rather dramatic event took place. It was taken due note of in the circles which keep a close watch on such matters but did not generate any significant debate. The said event was the drastic fall in the Shanghai Stock Exchange and the larger questions that it raised were with respect to the functioning of the Chinese economy, the role of the state, the hybrid nature of the Chinese economy and inevitably, the ability of the leadership to stem this or prevent similar crashes in the future. Finally, doubts were raised about China’s ability to take a leading role in the shaping of the new regional or global economic order. It is debatable whether this sideshow cast any shadows on the Chinese performance at the BRICS and SCO, though there were sharp critiques of the Chinese state and the ruling communist party (Fisher 2015; Wertime 2015; Rapoport 2015; Erickson and Collins 2015).

The Shanghai stock exchange composite index is a capitalisation-based index. This index was operationalised in December, 1990. The Shanghai Composite is the world’s third largest stock market. Its domestic market capitalization value reportedly stood at US$ 5.9 trillion towards the end of May, just behind New York Stock

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\(^1\) BRICS is an acronym for an association of five countries, namely, Brazil, Russia, India, China and South Africa. The 7th BRICS summit was held on 08-09 July, 2015.

\(^2\) SCO stands for Shanghai Cooperation Organisation. The 15th SCO summit was recently held on 10 July 2015.
Exchange (US$ 19.7 trillion) and Nasdaq OMX (US$ 7.4 trillion).\(^3\)

**The Background**

The Shanghai stock market grew by 152% since July 2014 and nearly 60% since the beginning of this year (Xinhua 2015), largely attributed to the Chinese government encouraging people in 2014 to buy more shares to boost the market. The exhortations were successful with the entry of a large number of new investors in the market including opening of new accounts in April-May (Xinhua 2015), as a result of a boom in margin trading\(^4\) (Hewitt 2015; Swanson 2015).

**Figure:** Growth of Shanghai Stock Exchange Index in past one year\(^5\)

Source: CNBC 2015

This boost to investment in stock market did not emerge in isolation. Rather, there were a number of statements by Chinese leaders, including the Chinese Securities and Regulatory Commission (CSRC) Chairperson Xiao Gang and leading news dailies such as Xinhua and People’s Daily which appeared to pump air into the Shanghai stock bubble from late 2014 to mid-2015. As David Wertime (2015) asserts:

“**In late August 2014, with the Shanghai Index still at a comparatively anaemic 2,201, state news agency Xinhua helped kick off the rally when it urged a ‘quality bull market.’ On April 21, with the index then at 4,293, state mouthpiece People’s Daily issued an article titled, ‘4,000 Is Just the Starting Point for a Bull Market in A-Shares,’ the type of shares a Chinese citizen can own. It was not an editorial, but like all Daily articles, it carried the implicit imprimatur of party approval. The market would gain another 20 percent thereafter before plummeting back to earth.”**

**The Crash**

Since 12 June 2015, China witnessed large fluctuations in the stock market and predictions about an impending fall in the Shanghai Composite and Shenzhen stock market have been doing the rounds even prior to that. On 2 July finally, the Shanghai Stock bubble burst when stock index fell below 4,000 points for the first time since April this year (Sweeney 2015). Over US $ 3 trillion were wiped off the country’s stock market since the slow down (Bolton 2015), leading to large scale panic among the investors. To get an idea of the sums we are talking about, this is the size of the entire French stock market; over 60% of Japan’s market (Riley

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\(^3\) World Federation of Exchanges 2015.

\(^4\) Margin trading refers to buying of shares with the money borrowed from the broker. It allows one to buy more stock than he/she could normally.

“Leverage has soared over the course of the rally. Outstanding loans to stock investors reached a record 1.67 trillion Yuan ($ 269 billion) as of April 13th, up some 300% from a year earlier” (The Economist 2015).

\(^5\) The stock exchange started rising since last summer and ended going up by many folds in June this year. This boost was halted when the stock market started showing the signs of the bubble burst in the second week of June, this year.
2015) and higher than the UK’s GDP in 2013 of US$ 2.7 trillion (Bolton 2015).

Furthermore, nearly half of the 2,800 companies trading in China chose to pull their shares out of the stock market (Yan 2015). And, this number continues to increase.

Reports indicate that about 80% of the investors are small-scale individuals hoping to make a quick buck and the huge drop of over 30% in the prices of company shares on the Shanghai stock exchange and drop of around 40% in the Shenzhen market since mid-June this year, injected alarm among millions of such individuals worried about the fate of their investments. Analysts have pointed out that small time investors in particular tend to make decisions on “a herd mentality” leading to a domino effect and a large-scale exodus (Smith 2015).

Seen as the biggest economic crisis of this decade in Asia, this is attributed to a sharper rise in the share prices, compared to a slower growth rate of the Chinese economy - at its slowest since 2009 - and the decreasing profits of companies since 2014 (Lee 2015; Swanson 2015b). Experts and investors have also been critical of China’s policies in past one year, which made it easier for people to get loans and invest in the market, leading to the huge increase in the number of investors in the stock market. This criticism is not restricted to merely market practices and the policies undertaken by the government. The new entry in the list of villains in China’s stock fall story is none other than Xiao Gang, the chairman of CSRC, himself. His reform agenda, targeted to make market less dependent on government interference, led to a manifold increase in the Shanghai stock index, but his policies and popularity increasingly came under the scanner when stocks started falling in mid-June. And his attempts to halt this drop any further attracted more criticism, when CSRC announced a ban on the selling of shares by big investors, company board members and others for six months (Qing and Takada 2015).

The Response

The Chinese government responded swiftly with major remedial measures including, among others, a sharp cut in the interest rates by the People’s Bank of China to boost liquidity, establishment of a 120 million Yuan fund⁶ by a group of 21 brokerage firms led by Citic Securities Co. to prop up the Stock market (BloombergBusiness 2015; Xinhua 2015e.), change in rules to ‘allow pension funds and the social security funds to invest more in stocks’ (Swanson 2015b).

These steps are being popularized and widely disseminated in national newspapers such as Xinhua:

Huge drop of over 30 % in the prices of company shares on the Shanghai stock exchange and drop of around 40% in the Shenzhen market since mid-June this year injected alarm among millions.

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⁶ Further confirmation in this regard is yet to come.
“In the previous trading days, China’s institutional investors have spent a huge amount of money in share purchase of heavyweights such as Sinopec and PetroChina in an effort to restore market confidence, but the move only ended in a short-lived rally... the central bank issued a statement reiterating its liquidity support to stabilize the market and avoid systematic and regional financial risks... China Securities Finance Corporation Limited, the national margin trading service provider, pledged to purchase more shares of small- and medium-sized listed companies to ease stock market liquidity.” (Xinhua 2015b)

All these measures were aimed at maintaining the investor’s trust in the market so that mass selling of shares can be prevented.

There are continuous statements from the Government, including from the highest levels, to check the panic among the public, ensure stability and reassure those affected that the government can handle any situation. The Chinese premier Li Keqiang in an effort to assuage concerns said that ‘China’s fiscal and monetary policies have been taking effect, while both development momentum and risk prevention capabilities were strengthened’ (Xinhua 2015c).

Many steps are also being taken by the stock market insiders such as commitment from the brokerages and fund managers to buy shares worth billions, announcement by the CSRC to suspend any new Initial Public Offerings (IPOs) and relaxation in the margin trading (Xinhua 2015d). Stock regulators have also gone to the extent of blaming the critical views put forward in the international and some domestic media and some experts, who are sceptical of any immediate recovery from this crisis, for intensifying the situation (Riley 2015b).

Furthermore, the Chinese Government, amidst rising panic in regard to falling stocks, had instructed the centrally-administered State-owned Enterprises (SOEs) not to sell their shares in their listed companies (Xinhua 2015b). All these measures were aimed at maintaining the investor’s trust in the market so that mass selling of shares can be prevented.

It is noteworthy that despite the drastic fall, the Shanghai stock exchange still remains 20% higher than it was in January 2015 and 74% higher than it was in June last year (Schiavenza 2015). Also, less than 15% of Chinese households have shares in stock exchange in China, whereas this number is quite higher in developed countries on average, which minimises the scale of a market crisis compared that in any developed capitalist economy.

The Implications

Though these measures are yet to show results, there are major questions of a general and more specific nature regarding China’s polity and economy.

First, did it have any impact on people’s confidence in the government’s ability to remedy the market? Clearly, if quick results had not materialised – as indeed they have - there would have been a serious negative impact on mass perception and possibly social stability. However, the situation is not completely out of the woods – and there are

According to Kaul (2015), around 34% of US households have shares in US stock market which is more than double the percentage of Chinese household shareholders.
apprehensions of a recurrence in the period ahead.

This leads to a second – and related - question regarding a possible dip in the influence of the CCP in the near future. Not Really. Though huge sums of the people are at stake in this roller-coaster ride within the stock market, people still see the stock market as a means of short term profit generation. However, this crisis might slow down progress in the Chinese state’s efforts to reduce the role of the government in economy, that is part of the next stage of the economic reforms. William Pesek (2015) among others, questions the economic reform agenda of the government:

“Xi has done little to recalibrate the economy. Exports and industrial production still dominate the Chinese economy, while the growth of small-to-medium-size enterprises has been underwhelming. And there’s little evidence that Beijing really intends on letting markets play a "decisive" role in the national economy.”

However, it is too soon to judge that the Chinese government is going to use this fall as means to keep its control on the market and avert the reform agenda of letting the market be a “decisive” factor. Moreover, the economic reform agenda involves a larger restructuring of the economy encompassing Center-local fiscal relations, foreign exchange and capital account liberalization, and wider trade and direct investment opening in services as well as manufacturing”, which are not directly dependent on the public equity market (Rosen 2015). Undoubtedly, it might take some years until this reform agenda is fully achieved - for now President Xi is not doing anything in hurry.

Third, how much should we be worried about this? Not much. Though it is an economic shock of sorts in Asia, the Chinese stock market is relatively isolated and it does not appears to have an impact beyond Chinese territory - relatively small numbers of foreign investors have put their money in Chinese stock market, which is less than 2% of Chinese shares (Klein 2015).

The issue of concern is, however, not the dip in the Shanghai Stock Exchange Composite and the fluctuating stock market, but its consequent impact on the second largest economy of the world’s which has the most extensive trade relations with almost every country in the world.

Amidst drastic fluctuations in stock market, some negative effects have started to show up. As reported in Finance Times, the slow growth rate of China along with turmoil in its stock exchange has impacted the “buyers’ cash flow” in China. It recently got reflected in drop in car sales in China (Mitchell 2015).

Here again, it could be argued that unlike the full-fledged market economies of the Western capitalist countries, the state/Party controlled Chinese economy is unlikely to be thrown off balance by this fall. There are other macro issues concerning the restructuring of the economy, which will have more significant and far-reaching...
consequences, both at the domestic level and the global economy.

How would it impact India? Not to any noteworthy extent. As Arvind Sanger, Founder & Managing Partner Geosphere Capital Management, points out:

“...China slowdown really is not much of an effect for India from an economic standpoint to the extent that India is very small exporter to China and much more of an importer to China. So there is not much of a trade hit that India takes from China slowdown. To the extent that that makes commodities cheaper that is a positive, not a negative for India. So, overall it is a non-issue for India” (sic).

Fourth, what would be the worst case scenario if stock market continues its downward spiral? It could result in a drastic fall in the market value of its listed companies (Wildau 2015), which not only include the manufacturing companies but also Chinese banks in huge numbers. The decrease in the value estimate of these companies could further create a situation of bankruptcy in very near future and have adverse impact on the China’s economy in terms of the manufacturing market and its exports if investor’s confidence in the stock market keeps falling.

Though the current situation does not appear to be a threat to foreign markets and trading countries, further drastic fall in the stock market could have an impact on many economies dependent on imports from China. However, it is unlikely that the Chinese state would let that happen.

Conclusion

The Shanghai stock exchange crisis did not have had the effect of plunging China into an economic crisis. Its role in and handling of the global financial crisis of 2008 notwithstanding, China appears to be no longer immune to the perils of market economic functioning.

The Chinese stock market remains volatile and highly unpredictable, even after the various measures enumerated above. It might take a while for China’s stock market to regain its high index but until then, questions about the effectiveness of the measures taken will continue to be raised. Long term remedies are clearly called for. The world’s attention would be focussed on Chinese leadership’s attempts to come up with a solution that revives not only domestic investors’ trust but also the confidence of foreign investors and China’s trading partners.

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9 For detailed list of listed companies, see the official website of the Shanghai Stock Exchange, http://english.sse.com.cn/listed/list/


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